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Remarks:

NSC review completed.

Executive Secretary  
11/29/05  
Date

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THE WHITE HOUSE  
WASHINGTON

9648-82 82-13929

## CABINET AFFAIRS STAFFING MEMORANDUM

DATE: 11/26/82

NUMBER: 077626CA

DUE BY: \_\_\_\_\_

SUBJECT: CCEA: November 30 Meeting: 8:45 AM: Roosevelt Room

	ACTION	FYI		ACTION	FYI
<b>ALL CABINET MEMBERS</b>	<input type="checkbox"/>	<input type="checkbox"/>	Baker	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Deaver	<input type="checkbox"/>	<input type="checkbox"/>
State	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Clark	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Defense	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Harper	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Attorney General	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Jenkins	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Interior	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Wheeler	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Kudlow	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
HHS	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
HUD	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Transportation	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
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OMB	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<u>CIA</u>	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
UN	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CCCT/Gunn	<input type="checkbox"/>	<input type="checkbox"/>
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OSTP	<input type="checkbox"/>	<input type="checkbox"/>	CCFA/Boggs	<input type="checkbox"/>	<input type="checkbox"/>
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	<input type="checkbox"/>	<input type="checkbox"/>	CCNRE/Boggs	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS: The agenda items for this meeting are: (1) Alternatives to Federal Regulation (CM 328); and (2) Interest Rate Targeting Legislation (CM 292). Papers are attached for both items.

*R*

RETURN TO:

 Craig L. FullerAssistant to the President  
for Cabinet Affairs Becky Norton DunlopDirector, Office of  
Cabinet AffairsDCI  
EXEC  
REG

THE WHITE HOUSE

WASHINGTON

November 24, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*

SUBJECT: Agenda and Papers for the November 30 Meeting

The agenda and papers for the November 30 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council is scheduled to consider two agenda items. The first is our approach to regulatory reform, the "third pillar" of the Economic Recovery Program. The first report of the Working Group on Alternatives to Federal Regulation, chaired by William A. Niskanen, is attached. Bill Niskanen will report on the Working Group's deliberations and Chris DeMuth will outline some ideas regarding the regulatory agenda for 1983 and 1984.

The second agenda item is a brief review of H.R. 7218, the Balanced Monetary Policy and Price Stability Act. The Council reviewed interest rate targetting legislation at its September 14 meeting. Since then, Congressman Kemp has introduced this additional legislation which he discussed with several administration officials earlier this week. A brief summary of his view outlined at that meeting is also attached.

Attachments

THE WHITE HOUSE

WASHINGTON

THE CABINET COUNCIL ON ECONOMIC AFFAIRS

November 30, 1982

8:45 a.m.

Roosevelt Room

AGENDA

1. Report of the Working Group on Alternatives to Federal Regulation (CM#328)
2. The Balanced Monetary Policy and Price Stability Act (CM#292)

First Report of the Working Group  
on  
ALTERNATIVES TO FEDERAL REGULATION

Summary

I. Introduction

Further progress towards deregulation is limited by the Administration's case-by-case approach to regulatory issues. The Administration ought now take a broad overview of regulatory policy and consider whether it has overlooked fundamental alternatives to present regulatory practices. This report is designed to provide such an overview. A second report to the Cabinet Council will develop and assess specified alternatives.

II. Traditional Arguments for Government Regulation

The economic justification for government regulation has typically been that markets are performing unsatisfactorily for one or more of the following reasons: natural monopoly, externalities, imperfect information, or excessive competition.

III. Problems with Existing Regulatory Processes

In practice, government intervention ostensibly designed to correct one of the foregoing market failures has often made markets work even less efficiently. Among the reasons for this are: First, politicians and bureaucrats do not have an incentive to allocate resources efficiently. Because of the nature of the political process, they tend to give too much weight to the interests of concentrated groups with large individual stakes, relative to the interests of large diffused groups with small individual stakes. Second, regulators generally have insufficient information to know if a policy will make matters better, and the cost of getting that information may be prohibitive. Third, centralized regulation tends to adapt slowly to new circumstances and to inappropriately set uniform standards for heterogeneous groups. Finally, regulations have a tendency to grow in scope as new regulations are needed to address the unintended consequences of earlier ones.

IV. Alternatives to Federal Regulation

What follows are several alternatives to the present form of Federal regulation with some possible applications.

-- Total deregulation. Example: eliminate regulation of trucking, railroads, ocean shipping, and natural gas.

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- Elimination of federal regulation. Example: eliminate the Federal highway speed limit.
- Change the legal standards affecting federal regulation. Example: reinforce the legal standard against broad delegation of authority to regulatory agencies.
- Change the form of federal regulation. Example: replace design standards on pollution control equipment with performance standards.
- Creation of marketable permits. Example: replace present allocation procedures for airport landing slots with marketable permits.
- Taxes and subsidies. Example: replace EPA automotive emissions standards with taxes on emissions.
- Liability rules and insurance requirements. Example: substitute increased liability and mandatory insurance for design standards affecting the transportation of hazardous materials.
- Information disclosure. Example: substitute labelling requirements for product standards set by Consumer Product Safety Commission.

ALTERNATIVES TO FEDERAL REGULATIONTraditional Arguments for Governmental Intervention

The Reagan Administration has made great progress on regulatory relief. The establishment of the Presidential Task Force on Regulatory Relief and the regulatory review procedure under Executive Order 12291 have substantially reduced the flow of costly new regulations. The President has also initiated other important deregulatory measures such as accelerating the phase-out of domestic crude oil and gasoline price ceilings inherited from the prior Administration.

As the mid-term approaches, however, some critics sympathetic to the Administration's goals have argued that the program of regulatory relief is losing momentum -- in part because the Administration has failed to develop and articulate a unified approach to regulation.

The reform program has taken on a stop-gap character because little further development of its rationale has been communicated to the public as time has passed. Regulatory policy has proceeded as if the invasion were still under way -- and perhaps it is. Unfortunately, progress towards durable reform is likely to depend importantly on the Administration's ability to make a strong case for its goals as well as its process for achieving them in the many areas affected by regulation ... What is needed now is a coordinated White House-agency effort that eschews the piecemeal regulation-by-regulation approach and relates action to a broad strategy for reform.<sup>1</sup>

This paper is an attempt to begin such a fundamental reassessment of federal regulatory policy -- questioning not only the techniques used by various regulatory agencies but the very existence of some such agencies. This is the first of two reports to the Cabinet Council. The second will develop specific alternatives to present regulatory practices in each of a number of economic sectors.

It would be doctrinaire to argue that the government can never improve upon the workings of free markets. What is

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<sup>1</sup> Marvin Kosters and Jeffrey Eisenach, "Is Regulatory Relief Enough?" *Regulation* (March/April 1982), p. 27.

needed is a careful evaluation of both the arguments which have been used to justify regulation, and the remedies designed to improve upon the alleged market defects.

The justification for government regulations has typically been that markets are performing unsatisfactorily for one or more of the following reasons: natural monopoly, externalities, imperfect information, or excessive competition. Each rationale is considered in turn:

#### Natural Monopoly

Economies of scale in some industries are such that the entire market demand can be satisfied at the least total cost by a single firm. Public utilities, such as local telephone service, electricity, and water are typically cited as examples of such "natural monopolies." It would be wasteful, for example, to have several power or telephone companies each lay cables when a single cable will do. Thus, for some industries, establishing a regulated monopoly may be preferable to promoting competition. The objective of regulation in the case of natural monopoly is to set the monopolist's price as close as possible to incremental cost (the efficient price) subject to the constraint that the monopolist doesn't lose money. Without regulation a profit maximizing monopolist would be likely to set prices too high and produce too little output in the sense that the amount consumers would be willing to pay for additional output (i.e. the monopoly price) exceeds the cost to the monopolist of supplying that output (i.e. incremental cost).

#### Externalities

A competitive market system may fail to achieve an efficient outcome if the actions of individuals or firms directly affect others outside the context of market interactions. In the presence of such spillovers or "externalities," private costs and social costs will diverge. The most important example of an externality is environmental pollution. If firms are not held responsible for the harm they impose by polluting the air and water, they may emit too much pollution, and may price their products below their total cost, which includes the cost of environmental harm from producing these products. Thus, too many such goods may be produced. Conversely, self-interested firms and individuals have too little incentive to produce and consume goods causing beneficial externalities. For example, too few people may receive vaccinations in the absence of government intervention, because they do not take into account the beneficial reduction in the chance of other individuals contracting a disease.

It is worth pointing out that government programs such as income maintenance, health insurance, and unemployment insurance may be thought of as creating negative externalities between the beneficiaries and taxpayers since such programs relieve individuals from bearing the full cost of their actions. For example, when a patient covered by Medicare visits a doctor the cost to the patient (private cost) is far less than the cost of providing the service (total cost), with the difference being paid by taxpayers. Thus the patient has an incentive to use too much medical care. The incentive for overuse exists even if the beneficiaries contribute to the program. The problem is analogous to that faced by a group that goes out to eat and agrees in advance to split the check. Each diner has an incentive to order too much because he knows that he will be held responsible for only a fraction of the amount his meal adds to the total bill.

This tendency of both public and private insurance to reduce an individual's incentive to conserve on the use of services covered by insurance has been used to justify additional government regulation. For example, the federally mandated certificate-of-need program has attempted to constrain the growth of hospital costs by regulating growth in the number of hospital beds. Note that the externality framework may simply be a useful way to examine some aspects of government programs. It is not necessarily true that "overconsumption" of medical care by insurance beneficiaries is inefficient. Such overconsumption may be efficient, for example, if it constitutes behavior valued by the donors, i.e., the taxpayers.

#### Imperfect Information

For the market system to function efficiently consumers must have sufficient information about quality and safety to evaluate alternative products, and workers must have enough health and safety information to choose appropriately among alternative jobs. Markets may, however, produce too little information about some products and jobs because producers of the information may be unable to appropriate its full social value. The tendency towards underproduction of certain information is a special case of a positive externality. To capture the full value of the information would require the producer to (1) be able to exclude people who don't pay for the information -- something which is likely to be difficult in the case of information since it can be reproduced on copy machines or passed on by word of mouth, and (2) price discriminate, i.e. determine how much each person is willing to pay for the information and charge him that price. In other words, markets may underproduce some types of information because it is difficult for nonpayers to be excluded from the use of information once it is

produced, and because potential users have incentives to understate their demands (valuation) of information in the hope that others will foot the bill. Note that discriminatory pricing is not necessary for efficiency: even if perceived demands are understated from the viewpoint of the producers, the (low) perceived demand may still be sufficient to induce production.

Firms are likely to have particular difficulty capturing the value of adverse product or job information -- information which would reduce the demand for a product or the supply of workers to a job. Consider, for example, a firm whose product is less safe than consumers believe but safer than the industry average. Such a firm would reveal this information only if it believed that the resulting increase in its market share would be great enough to outweigh the reduction in total market size. Other industries, however, may have an incentive to produce such information as a means of increasing demand for their products.

Failure by consumers and workers to reveal certain information can also result in allocative inefficiency. For example, potential purchasers of life, health, or disability insurance may not reveal their true physical condition. And those people who are more likely to collect insurance payments tend to be the ones more likely to purchase insurance. In some cases this tendency towards "adverse selection" may lead to a total breakdown of an insurance market. One possible policy to deal with such adverse selection is to require mandatory insurance. Social security disability coverage and mandatory health coverage have sometimes been justified on this basis.

Note that the cost of producing information is conceptually identical to the cost of producing iron ore, and therefore by itself is not a source of inefficiency. It is instead the external benefits provided by information and the efforts of individuals to hide or obscure some types of information that may produce allocative inefficiency and a possible role for government.

#### Excessive Competition

The regulation of price and entry in industries such as airlines, trucking, rails, ocean shipping, telecommunications, and banking has often been justified with the argument that unfettered markets would result in "excessive competition," a term that has never been defined clearly. The term has been used to signify at least three possible sources of market failure: natural monopoly, cyclical demand with "imperfect" capital markets, and predatory pricing.

As explained earlier, in the case of a natural monopoly, competition can lead to higher costs of production than if a single firm produced the entire output. It has been argued that rivalry among firms to determine who should be the single producer leads to wasteful duplication of capacity and hence should be prevented by government regulation. It should be noted that this definition of excessive competition should not be applied to airlines, trucks, or shipping because they are not natural monopolies.

A second interpretation of "excessive competition" is based on the argument that certain industries (industries with cyclical demand and heavy fixed investment) are prone to excessive price fluctuations. It is sometimes claimed that, because of (unexplained) imperfections in capital markets, firms are forced to close down during recessions and then unnecessarily incur large start up costs when the business cycle turns up. These wasteful shutdown and startup costs could be avoided, it is argued, if government regulation set minimum prices or allowed firms to do so.

The third interpretation of excessive competition focuses on price regulation as a tool to combat "predatory pricing". Unregulated competition is alleged sometimes to result in the monopolization of a market by a firm engaging in predatory pricing -- charging below cost in order to drive out competitors. To be successful, a predator must be able to outlast his rivals and there must be barriers preventing entry of new competitors once the predator raises prices. Regulation preventing firms from charging excessively low prices is supposed to prevent such predatory practices and hence avoid the high monopolistic prices which would prevail once the predator has eliminated his competition. Note that no consensus exists among economists in favor of the presumed efficacy of such predatory tactics. Indeed, many economists believe that "predatory" behavior, if ever successful, must be a manifestation of other true cost advantages, such as lower risk.

#### Problems with Existing Regulatory Processes

The traditional rationale for economic regulation described above can be summarized as an attempt to substitute nonmarket decisionmaking and processes for market ones when the latter lead to various kinds of market "failure" or allocative inefficiencies. This rationale is the product of the older welfare economics tradition within public finance: what are the conditions characterizing "efficient" resource allocation, and what kinds of institutional frameworks can be expected to lead to such outcomes? The general answer has been that competitive markets generate forces leading to such allocative solutions. While general, this conclusion is not

universal: it is recognized by the traditional analysis that certain kinds of situations lead even competitive markets to socially inefficient outcomes, for reasons discussed above. The traditional welfare economics literature then examines the role of the state in a normative framework: what public policies will correct such limited failures of the competitive market?

It does not ask a related but much different question: how can government policy be expected actually to evolve -- that is, how can governments be predicted to behave -- given the institutional setting and incentives faced by both decisionmakers and the citizenry? This newer line of inquiry focuses on questions of more immediate interest: why do observed policies seem clearly not to lead to greater efficiency in the face of seeming market "failure," and are there alternative policies that can be expected to produce net improvement? Several reasons can be cited for the apparent failure of standard regulatory policy. We defer to the later report on individual policies a discussion of conceptual problems with the basic rationales for regulation.

First, regulators cannot know what the optimal resource allocation is, nor do they have incentives to learn what it is or implement it were it known. Regulators typically have relatively short terms in office; they enjoy no benefits from improvements in allocative efficiency, and may be subject to various perceived penalties should they fail to satisfy at least partially the demands of important interest groups. However well-meaning regulators may be, the absence of rewards for allocative improvements means that the regulatory process is very likely to lead in directions other than that envisioned by the traditional argument. In contrast, powerful incentives -- profit and self-interest -- generally lead competitive markets toward solutions that are socially efficient.

Second, incentives for particular individuals and groups to bring information to and pressure regulators are directly affected by the stake that these individuals and groups have in the specific issues. This leads to an important and inevitable bias in the range of views and information presented to regulators: the interests of concentrated groups with large individual stakes in the decisions will tend to loom large before the regulators relative to the interests of diffused groups with individually small stakes in the outcomes. Hence, the process tends to emphasize the interests and arguments of concentrated interests, even if satisfaction of their interests leads toward less allocative efficiency.

Third, because regulations and decisions must be enforced, regulators are driven to emphasize concepts and parameters that can be measured, even if these measurables constitute the wrong focus or if they bear little or no relation to the correct underlying concepts at issue. Thus, price regulation is forced to emphasize historical or accounting costs instead of economic (opportunity) costs, and usually ignores demand considerations at least in part. Some environmental regulation emphasizes particular kinds of equipment and other inputs instead of the less tractible but more fundamental issue of actual environmental effects.

Fourth, centralized decisionmaking simply lacks the flexibility characterizing decentralized activity: regulatory bodies tend toward inherent conservatism, allowing precedent a large voice in current issues, and displaying rigidity and inflexibility. This means that regulatory decisionmaking tends to be characterized by a failure to respond to changes in the economic setting, changes which are a continuous factor in a dynamic world. Hence, regulation by its nature tends to inhibit innovation.

Fifth, because regulation imposes nontrivial costs upon individuals and firms, those affected have incentives to make investments in efforts to change and evade the regulatory outcomes. This use of resources is a real cost, and may on net result in regulation making society worse off than the absence of regulation.

Sixth, because regulation inevitably must impose standards and decisions that are more or less uniform, it tends to produce homogeneity rather than heterogeneity, thus inhibiting the experimentation that is the source of much of society's improvement over time.

Seventh, regulators have few incentives to discover least cost solutions, particularly if such solutions would be politically unpopular. Thus, regulation often tends to force adjustments by others than those that could do so at least cost.

Finally, the scope of regulation has a built-in tendency to expand. This is because regulation tends to produce new inefficiencies; these new induced problems create demands for regulatory solutions, which create still more problems and inefficiencies at which the regulators can throw only more regulatory solutions. This dynamic produces calls for more and more centralization which becomes less and less flexible and which produces more and more new problems. In short, regulation tends over time increasingly to become the overriding source of problems instead of solutions.

The following section outlines some alternative approaches to economic regulation. The present approach being used by the Administration -- careful review of existing regulations and of proposed new ones -- is inherently limited to a case-by-case approach, it does not produce fundamental change in the approaches and incentives of government, and on net is likely only to slow the growth of costs being imposed upon the economy. The application of the benefit/cost criterion is limited by other criteria in existing legislation, because benefits and costs often are difficult to measure and relatively easy to manipulate and, more fundamentally, because political processes lead to strong incentives to focus upon distributional effects rather than on allocation effects.

#### Alternatives to Federal Regulation

The appropriate alternative to a particular federal regulation depends on the nature of the unregulated marketplace problem the regulation is designed to address. The menu of available alternatives includes total deregulation, defederalized or local regulation, a change in the legal standards affecting federal regulation, the replacement of design standards by performance standards, the development of marketable permits, change of tax policy, the use of liability (together with private insurance markets) law, and the dissemination of information. The application of these alternatives to specific market problems is summarized below.

In cases where the rationale for regulation is "excessive competition," which has been shown to be an incoherent and misleading argument, the appropriate policy is total deregulation. This policy has been successfully pursued in the airline industry. The passage of the Airline Deregulation Act of 1978 resulted in lower fares, the elimination of unusually costly service, and the expansion of consumer choice. It has also provided greater airline service to most communities, both large and small. Additionally, the increased flexibility has allowed the airlines to improve productivity and efficiency. Deregulation of the securities industry through the Securities Act Amendments of 1975 has also increased the benefits to consumers of the services of the stock brokerage industry. Investors now enjoy a greater variety of brokerage services at substantially reduced prices. Similar gains might be achieved by applying this policy to the natural gas, trucking, railroad, and maritime industries.

The policy of defederalization, or localized control, is appropriate when the rationale for regulation is the existence of "spill-over effects" or externalities characterized by local or limited damage. In such cases, the level and methods of controlling the behavior of those generating and the spill-overs

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are best determined by local authorities. The imposition of a national standard on communities with highly disparate conditions is likely to be extremely inefficient and undesirable. The most obvious example of a federal regulation which should be replaced by state standards is the federal highway speed limit. The provision of safe-drinking water provides an excellent example of the existence of a federal policy which could be more efficiently and effectively promulgated by local authorities.

For some years, scholars have been considering several generic approaches to discipline all federal regulation. One such approach is embodied in several bills now being considered in Congress. These bills, in effect, would give statutory authority to Executive Order 12291, require that all regulations meet a benefit-cost test except where precluded by other laws, and provide for a legislative veto of specific regulatory decisions. Such legislation would be helpful but would not correct the fundamental problems of existing regulatory legislation or the inherent limitations of benefit-cost analysis. Another approach would be to revive a stronger interpretation of the "takings clause" of the Fifth Amendment. This approach would involve narrowing the concept of "public use" and broadening the concept of "taking" and the required "just compensation" (to include any substantial reduction in the value of private property). Another interesting approach would be to revive the legal doctrine that "a delegated power cannot be delegated." A reenforcement of this doctrine would inhibit Congress from delegating broad authority to a regulatory agency. Since the legislative process involves numerous veto groups, there is reason to believe that restraints on delegation would reduce the total amount of regulation. These several legal restraints on undue regulation have been substantially eroded by the courts during the last 60 years but could presumably be revived by legislation or by future court decisions.

In some cases where it is appropriate to maintain federal standards, it would be valuable to replace design standards with performance standards. Many federal pollution standards specify the characteristics of the pollution control equipment. Replacing such design standards with performance standards on the allowable pollution would permit firms to choose the most efficient means to achieve a given environmental standard. Similarly, many design standards affecting workplace safety could also be replaced by safety performance standards.

Taxation and the creation of marketable permits are policies that can be utilized, instead of standards, to address the problem of "spill-over effects" (externalities) causing widely-dispersed damages. These policies provide incentives for

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those creating the external effects to take into account the costs that their activities impose. Additionally, by providing greater flexibility, taxation and marketable permit policies avoid several of the pitfalls associated with classical regulation via standards. For example, both may be less likely to result in prohibition of an activity or total suppression of a product. Consequently, those with special needs and a willingness to pay may engage in the activity. Both policies minimize the relationship between regulators and firms, thus mitigating the protectionist instinct present in much of classical regulation. Moreover, both policies provide incentives for technological change and innovation to reduce the damages created by the activity causing the spill-overs. The attempt by the Environmental Protection Agency to develop workable "emissions trading" programs to achieve the mandates set forth in the Clean Air Act is an application of the concept of marketable permits. Other applications of this policy could be made whenever the government allocates a scarce resource, such as the rights to take-off and landing slots at congested airports. Special pollution taxes could be applied, for example, to mobile source pollution such as automobile emissions. Note that government does not necessarily have incentives to impose the efficient tax rate; it may impose instead the rate that maximizes revenue. Nonetheless, improvements over present policy may result.

Financial incentives may also be used as an alternative to regulations designed to reduce the possible overuse of services covered by social insurance programs. For example, a requirement that Medicare beneficiaries pay a share of their hospital costs, through institution of a system of deductibles and copayments, is probably a better way to contain hospital costs than are attempts to regulate the number of hospital beds.

The development of clear liability rules and conventions coupled with private insurance markets may be substituted for standards in the health and safety areas. Liability rules have traditionally been the cornerstone of strategies for controlling risky behavior: those who undertake risky activities are often held financially responsible for their actions, even without evidence of intent to cause harm. Appropriate specific liability rules provide incentives to undertake the proper amount of the risky activity, both in terms of the benefits and costs of the activity imposed on all parties concerned. A liability-based policy would be particularly appropriate in the transportation of hazardous materials and the attainment of vehicular safety, two areas in which the effects of standards setting have been shown to impose heavy costs without corresponding consumer benefits.

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Finally, in situations where the lack of information about product quality or workplace safety is the rationale for standard setting, policies of information provision or certification may be appropriate. Such programs allow consumers and workers to make more informed judgments about the products they buy and the employment they accept. These information-based policies may be particularly appropriate when the deleterious effects of consuming a product or working in a specific environment are long-lived and difficult to determine, as is the case with some pharmaceuticals and job-related health hazards.

Note that none of these policies is "perfect" in any sense. However, each may produce improvement over existing policies in given areas. Such specific comparative analysis will be the focus of the subsequent working group report.

THE WHITE HOUSE

WASHINGTON

November 24, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*

SUBJECT: H.R. 7218 - The Balanced Monetary Policy and Price Stability Act

On Monday, November 22, several administration officials met with Congressman Jack Kemp to discuss his Federal Reserve Board legislation, the Balanced Monetary Policy and Price Stability Act. The meeting served to clarify several points.

Kemp's view of his bill is that it is not an interest rate targetting bill but rather legislation to produce a balanced monetary policy that will assure price stability and economic growth.

He emphasized two goals: First, easier money in the next year or two to assure an adequate recovery. In this he sees a monetarist approach as the obstacle. His second goal is price stability. He prefers to define this in terms of an index of industrial raw materials on the ground that it is an earlier warning signal of subsequent movements in the consumer price index. He is also attracted to attempting to stabilize the price of gold but recognizes that this is not politically feasible at this time.

His proposed legislation subordinates interest rate targetting to price stability, but he emphasized that the important feature is that price stability would be given more weight than other factors. In practice, the Federal Reserve would have considerable latitude, in his view, to pursue a balanced approach taking prices, exchange rates, economic activity, etc. into consideration.

One obvious danger is that the legislation would provide support for the notion of interest rate targetting, an approach that the Cabinet Council discussed as undesirable in our review of interest rate targetting legislation on September 14.

The Council will briefly discuss H.R. 7218 at its meeting on Tuesday, November 30, 1982.